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SUBJECT: GOS TO PURSUE PHASED PRIVATIZATION OF OIL COMPANY

SUMMARY AND COMMENT

¶1. The GOS will move forward on a draft privatization strategy for state-owned oil and gas company Naftna Industrija Srbije (NIS) submitted by adviser Merrill Lynch, according to the head of the privatization steering group. In a recent meeting, Slobodan Sokolovic, Assistant Minister of Energy and Mining, confirmed that the GOS will approve the strategy in all its key aspects at its council of ministers meeting on July 6. The strategy calls for a three phased- approach to privatization under which the strategic investor initially would purchase a minority share in the oil company, but with full management control, with a more-or-less guaranteed right to acquire a majority stake.

¶2. This strategy is certainly second best to an immediate sale of majority ownership to a private investor. Unfortunately, various political interests have once again prevented taking the most direct path to a fully free-market situation. That said, if the GOS actually moves forward with this plan, the sale of NIS, whose revenues are more than eight percent of GDP, would be a major step forward in decreasing state control over the economy. END SUMMARY AND COMMENT.

DRAFT PRIVATIZATION STRATEGY SUBMITTED

¶3. Econoffs met with Slobodan Sokolovic on June 20 to discuss the Government's view of the draft privatization strategy of NIS. Sokolovic, who also leads the GOS steering committee on privatization, described a three-phased approach to privatization that will include an immediate change in management control of the company. He said that he expects the Government to approve the strategy as presented at its July 6 session. This tender likely will open in October, after Merrill Lynch prepares the documentation necessary, Sokolovic said.

¶4. The strategy lays out three phases. The first phase calls for selling 35 percent of NIS as an integrated company to the strategic partner with a complete transfer of management control. Sokolovic explicitly said that management control will include investment decisions, with no veto power remaining with the GOS. After the initial transaction, the state of Serbia will have 40 percent in NIS, the potential buyer 35 percent, Serbia's Share Fund, 18 percent and NIS workers, 7 percent.

¶5. Phase two, to take place in three years, will permit the strategic partner to purchase an additional stake in the company to bring its share up to 51 percent. Sokolovic said that this would be guaranteed as long as the strategic partner meets certain benchmark investments, the key one being the investment of USD 300 million to bring refinery products up to European standard. The final phase would allow the strategic partner to purchase the remaining stake

in the company after Serbia joins the European Union (EU).

¶6. When econ chief asked how the buyer would be guaranteed majority ownership in phase two, Sokolovic said that such specific elements had not been fully defined; Merrill Lynch will make recommendations on this and other implementation issues. However, one solution could be an Initial Public Offer (IPO).

¶7. Sokolovic said that the reasons why the GOS does not want to sell the majority in NIS immediately can be explained by the GOS objectives in carrying out the privatization: to retain an integrated oil company that can compete in the region, and to create a dynamic company that will also promote growth in other parts of the economy. Other objectives include creating a competitive market and attracting strategic investors who will invest and modernize the company and produce Euro-quality products. Sokolovic acknowledged that the two-phase strategy was intended to guarantee the government that the investments take place before it authorizes the majority transfer.

¶8. On June 19, Merrill Lynch presented the strategy to the NIS Managing Board and NIS Trade Union. The Board allegedly fully accepted the strategy, despite its intense media campaign to stave off privatization through a variety of stratagems: sale of a low percentage to a consortium, "first-modernization, then-privatization," etc. (Merrill Lynch reports having consistent problems in getting data out of the company.) On the other hand, Sokolovic said that the trade union only expressed interest in the distribution of shares for union members, e.g., when they would be able to cash them in.

¶9. According to terms of reference for the privatization advisor, in the second phase Merrill Lynch will present a detailed analysis of all aspects of the privatization: operational, financial and legal due-diligence; environmental review; valuation of the company and preparation of the tender documentation. Merrill Lynch is responsible for preparing each phase of the transaction process to give potential investors a clear picture of the privatization process.

¶10. The final, implementation phase, will encompass the following: launching and managing the bidding process; managing the due-diligence; collection and evaluation of bids; managing and/or conducting negotiations; preparing of the Final Legal Documents and advice on and support the closing of the transaction.

OTHER OUTSTANDING ISSUES TO BE RESOLVED

¶11. Other controversial issues like whether to let consortiums bid on the tender, the amount of social program, or compensation, for workers to be released, and how to value shares in the second transaction, will be worked out by Merrill Lynch in the next phase of their work, Sokolovic said. He said that Merrill Lynch will seek to define conditions under which consortiums could participate in the tender without the fear that NIS will be split into parts after privatization.

¶12. With regard to regulatory issues, Sokolovic explained that some sort of import tax for crude oil and oil products will be maintained for another three to four years after privatization of NIS, to give NIS and a future strategic partner more time to modernize its refineries ahead of privatization. The decree banning imports will be replaced by an import excise that will decline over time, while pricing will become an automatic mechanism that will no longer require Ministry of Finance approval. (However, the Government only days ago extended its decree banning companies other than NIS from importing oil derivatives, except euro diesel 4, through the end of 2010.) (Note: Prominent economist Kori Udovicki, a former central bank governor, attacked the GOS's move to extend the decree, but in the same statement she also called for a declining tax to

replace it, similar to what Merrill Lynch has proposed.)

¶13. When asked whether the Ministry was concerned that a decline in oil prices over the next few years could impact the valuation of the company three years down the road, Sokolovic said that Merrill Lynch's projections foresee the price of crude oil and refinery margins remaining high over next five years. Sokolovic mentioned that the Petrohemia complex in Pancevo, which is linked in every way to processing of oil in the refineries, will be privatized separately from NIS, but Merrill Lynch will handle the process in parallel with NIS privatization.

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